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TAGS: ECON EINV ENRG EPET PGOV YM
SUBJECT: OIL: ROYG MORE TRANSPARENT, BUT CHALLENGES REMAIN

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¶B. B. 2006 SANAA 916
¶C. C. 2006 SANAA 3342

Classified By: Ambassador Thomas C. Krajeski for reasons 1.4 (b) and (d
)

¶1. (C) SUMMARY: Yemen's oil production, which constitutes 75 percent of the national budget, continues to decline in 2007, with high prices masking the effects of lower production. In order to increase production, the ROYG has decided to double the number of exploration blocks, will launch a fourth international bid for offshore oil blocks in the summer, and continues construction of the Yemen Liquefied Natural Gas Project (YLNG) as an alternate source of income. Tensions between international oil companies and the ROYG persist despite a general improvement in relations, as demonstrated by the Hunt Oil court case over Ma'rib Block 18 and challenges to the "Yemenization" of the workforce. END SUMMARY

NUMBER OF OIL BLOCKS IS UP . . .

¶2. (C) Yemen is a non-OPEC oil producing country, with proven reserves of four billion barrels (reftel). In 2007, the ROYG designated a total of 97 blocks, 12 of which are currently producing with exploration in 40 others. The number of producing blocks remains unchanged since 2006, the number of exploration blocks has doubled (from 20 to 40), and the total number of blocks has increased by 13 (from 84 to 97). Thabet Ali Abbas, Deputy Chairman of the Petroleum Exploration and Production Authority (PEPA), told Econoffs on May 29 that the reason for the increase was the resolution of border disputes with Eritrea and Oman, representing a geographical area of 7,000 square km.

. . . BUT PRODUCTION IS DOWN

¶3. (C) Oil revenue comprises 70 percent of the national budget, but production continues to fall. It peaked in 2001 at 471,000 barrels per day (bpd), was 365,000 bpd in 2006 and is 330,000 barrels per day currently. Ahmed Abdullah, Chairman of PEPA, attributed the decline to drops in oil production in Masila-Hadramawt Block 14 and Mar'ib Block 18 (where Hunt Oil was located until its contract was cancelled in 2005). Nevertheless, he expected high oil prices, which were three times higher in 2007 than in 2002, to compensate for the drop in oil production. The Central Bank of Yemen confirmed that official oil revenues were higher in 2006 than in 2002 despite lower production levels: the value of oil exports was USD 1.6 billion dollars in 2002 compared to USD 4 billion in 2006. Abdullah also predicted new oil discoveries will be made during 2008 in Block 10 (operated by the French

Total Company), Block 9 (operated by the Canadian Cavalley Petroluem Company) and Block S2 (operated by the Austrian OMV), which would boost oil production by at least 45,000 bpd.

¶4. (C) Oil company executives are skeptical about PEPA's optimistic outlook. Canadian Nexen President and General Manager Alistair Mooney opined in a June 1 meeting that any new discoveries would be minimal and may not offset the decline in production, which is a univeral phenonomenon. Mooney said that Nexen's wells in Block 14 produce 94 percent water and only 6 percent oil. He also remarked that Yemen currently has 55 exploration wells in the country and that "the real question to ask the ROYG is how many of these exploration wells have been drilled?"

BIDDING ON OIL IN YEMEN

¶5. (U) In order to attract international investment to boost oil production, on December 9, 2006, PEPA announced its decision in the third international bidding round for oil blocks. PEPA awarded eight blocks to five international companies: 1) Block 19 (in al-Jawf) and Blocks 28 and 57 (in Shabwah) to the Indian JSPC Company; 2) Blocks 82 and 83 (in Hadramawt) to the Indonesian Medco Energy Company; 3) Block 17 (in Aden-Abyan) to the British Burren Energy Company; 4) Block 29 (in al-Mahrah) to the Austrian OMV Company; and 5) Block 84 (in Hadramawt) to the Norwegian DNO Company. Economic obervers' overall opinion of the third bidding round was that the process was run transparently, a belief held even by companies that failed to win a concession.

¶6. (U) Abbas told Econoffs that the ROYG awarded Block 4 (in the Shabwa province) and Block 39 (in the Mahra Province on the Gulf of Aden near the Oman border) to the Korean National Oil Company (KNOC) on May 30. He said that KNOC would own a 50 percent share of Block 4 and the ROYG-owned Yemen Company for Investment in Oil and Minerals (YICOM) would own the remaining share. KNOC would also own a 95 percent share of Block 39, and YICOM would own the remaining 5 percent.

¶7. (C) Abbas informed Econoffs that PEPA will launch the fourth international bidding round for oil blocks in June or July 2007, covering at least three new offshore blocks in the Red Sea, Gulf of Aden and Socotra. The fourth international bidding round is divided into six phases, which would last at least six months: 1) Advertising and Receipt of Applications; 2) Pre-Qualification Phase; 3) Accessibility Phase of pre-qualified companies to data and information about the oil blocks; 4) Distributing standard offering forms and draft contracts to the competitors; 5) Reception of bids in sealed envelopes; and 6) Advertising competition results. Eligibility critirea for companies submitting bids are: 1) that they have sufficient technical experience to operate and run oil blocks; 2) they have capital of at least USD 50 million; and 3) they have a good environmental record. Decisions on the bid may be announced by the end of 2007.

YLNG PROJECT ON TRACK,
DESPITE OBSTACLES

¶8. (C) Yemen at present does not produce or export any natural gas, but in order to combat lower oil production, the ROYG decided to construct the Yemen Liquefied Natural Gas Project in partnership with Total. YLNG Deputy General Manager Karim Abu Hamad reported on May 21 that construction of the project is 55 percent complete and expects gas deliveries to begin at the end of 2008 or the beginning of
¶2009. Projected LNG deliveries will be 6.7 million tons per

year, two-thirds of which will be exported to the United States. While construction of the 320 km pipeline between Balhaf and the Ma'rib Block 18 gas field is behind schedule, Abu Hamad believes that YLNG will be able to pump gas through the pipeline by December. He added that construction is behind schedule at the upstream gas extraction facilities in Ma'rib Block 18 because of legal disputes between Hunt Oil and the ROYG over 1) ROYG's alleged violation of a five-year extension agreement with Hunt in 2005; and 2) who should be the operator of the upstream facilities-- the ROYG-owned Safir Company or the Marib Services Company (which is partially owned by Hunt). The Safir Company is the current operator. (Reftel B)

¶9. (C) Technical problems at the Ma'rib Block 18 gas field persist. In a May 28 meeting with Econoff, Jannah Hunt Oil General Manager Michael Graham asserted that the Safir Company is cutting corners in its operations at the gas field. In Graham's opinion, Safir Company does not maintain sufficient pressure in extracting gas and oil from the ground. Lack of sufficient pressure will cause production to plummet. Graham opined that "we will have to get in there to upgrade the gas plant."

¶10. (C) YLNG Deputy GM Hamad disagreed with Graham's analysis, arguing that "the only difference between the Safir Company and Hunt Oil is 41 Americans." He believed that gas production would be the same under either company, at 60-70,000 bpd. The root of the problem, according to Hamad, is that the Gas Development Agreement Law # 2 of 1997, which governs Ma'rib Block 18, did not foresee the involvement of Safir Company.

HUNT OIL GOES TO COURT

¶11. (C) Regarding the first legal dispute mentioned in paragraph 6, Graham claimed that both the ROYG and Hunt Oil Company signed a 5-year extension of the production sharing agreement (PSA) in 2005, and that the Minister of Oil endorsed the agreement. However, the Yemeni Parliament "did not like the agreement and wanted Hunt Oil out of Block 18," he said. (Note: All PSAs in Yemen legally require Parliamentary approval. End note). The cabinet of then-PM Bajammal terminated the new PSA on October 18, 2005 and handed Block 18 over to the ROYG-owned Safir Company. Graham said that Hunt Oil is suing the ROYG for lost revenues and that hearings will take place in September 2007 at the International Commercial Court in Paris. He expects Hunt Oil to win the lawsuit and that the ROYG may even settle before

the court's ruling. If the ICC rules in Hunt Oil's favor and the ROYG ignores its ruling and exports Block 18 oil, the oil/profits could be confiscated at the importing countries' ports and turned over to Hunt Oil, according to Graham.

OILY RELATIONS WITH ROYG

¶12. (C) Despite the ROYG's treatment of Hunt, overall relations between international oil companies and the ROYG are cordial, according to local company representatives. Graham said that he generally meets with MOM officials every two weeks. Canadian Nexen President Alistair Mooney, who has been operating in Yemen since 1992, told Econoff that the ROYG is "a lot more transparent than in the past in its dealings with the oil companies," especially since Yemen expressed its intention to join the Extractive Industries Transparency Initiative (EITI) in March 2007. Oil Minister Khaled Bahah reassured the CDA in a December 24, 2006 meeting that MOM personnel are more fully engaged than in the past with oil companies. (Note: The Minister is also a former employee of Canadian Nexen (Reftel C). End note)

¶13. (C) Despite these positive developments, basic tensions remain. For example, the ROYG requires at least 90 percent of the oil companies' workforce to be Yemeni. Mooney said that in May 2007, Canadian Nexen's workforce was only 83 percent Yemeni, due to the challenge of finding skilled Yemeni labor. Companies also face pressure to hire family members for subcontracts. The Jannah Hunt Oil Contract Manager, an Amcit, said that one Yemeni tried to force her to hire another Yemeni for a contract and that if he had his way, "she would be replaced by a Yemeni."

COMMENT

¶14. (C) International experts predict that Yemen will run out of oil in 15-to-20 years, a slow decline that is already underway. The ROYG has decided to battle this trend on a number of fronts: by increasing the number of exploration blocks, trying to attract foreign direct investment through international bidding rounds on oil blocks, and diversifying to natural gas production. The ROYG has made strides in becoming more transparent, but more progress needs to be made, a fact made plain when the ROYG released its FY 2007 budget in February, which the media attacked for allegedly underreporting oil revenues by 25 million barrels (i.e. USD 1.36 billion). For "Yemenization" to succeed, the ROYG also needs to do a better job ensuring that there are enough Yemenis who are well-trained to carry out oil exploration and production activities. Even with these fixes, there is little doubt among observers that the slow decline of the Yemeni oil sector is inexorable, barring a major new discovery.

KRAJESKI